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An Analysis of the Marital Deduction in Estate Planning

I. BACKGROUND

A. *Scope*

The marital deduction is the single most important federal estate tax deduction available to a decedent leaving a surviving spouse¹ and is both the foundation of any family estate tax plan and the primary source of revenue available to meet the needs of the surviving spouse. The complex nature of the marital deduction makes it a powerful weapon for the thoughtful and sophisticated estate planner, as well as a trap for the unskilled practitioner. The goal of this comment is to extract from the maze of statutes, regulations, and articles a concise survey and analysis of the marital deduction.

B. *Historical Description*

The original objective of the marital deduction was to ensure some parity in the tax treatment of gifts and estates with respect to interspousal transfers in common law and community property states.² The premise of "community property" is that each spouse owns an individual interest in all property acquired by either spouse during coverture, exclusive of gifts, devises, and inheritance. One-half of community income is considered to be realized by each spouse. The aggregate income therefore was subjected to lower tax brackets.³ As each was considered to own one-half of the community property, gifts to others were taxed one-half to each spouse, for husband and wife respectively contributed one-half to the gift. More importantly, taxation of one-half of the community property at the time of the first spouse's death was unnecessary, since the survivor

1. I.R.C. § 2056. All Code citations refer to the Internal Revenue Code of 1954 unless otherwise indicated. The interplay of the marital deduction with numerous other Code sections demonstrates its significance.

2. See Berall, *Marital Deduction Changes*, in 2 ABA-ALI STUDY OUTLINE, THE TAX REFORM ACT OF 1976: ESTATE AND GIFT TAX PROVISIONS 25, 25 (1978) [hereinafter cited as Berall].

3. The advantages of such "income splitting" were negated by the joint return privilege now afforded to all married persons. See 1 RABKIN & JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION § 5.05 (1976).

was considered to own that portion.⁴ Thus only the decedent's portion of the community property is included in the gross estate.⁵ "Estate splitting"⁶ gave spouses in community property states a considerable edge over spouses living in common law jurisdictions, due to the progressive rate tax structure for families residing in common law states. Often all of the family wealth was taxed at the death of the common law wage-earning spouse. To minimize the estate splitting advantage of community property spouses, it was necessary to allow residents of common law states to bequeath one-half of their property to the surviving spouse tax free.⁷ The equalization mechanism devised by Congress, the marital deduction, was an additional deduction allowed to residents of common law states in computing their taxable estate.

The marital deduction was designed to allow one spouse to transfer property to the other and receive the same tax treatment as if the property had been transferred in a community property state. The recipient spouse had to acquire essentially the same property rights that a surviving spouse would have received in the community property. In other words, for property to qualify for the deduction, the spouse must have received an interest in the property that results in inclusion in the gross estate of the surviving spouse.⁸

Obviously, the chief impact of the marital deduction is tax defer-

4. See Schlesinger, *Practical Aspects of the Marital Deduction and Minors Deduction: When to Use and How to Use*, in 2 ABA-ALI ESTATE PLANNING IN DEPTH 1007, 1007 (4th ed. 1971). In accordance with census statistics, this comment will assume that the husband is always the first to die. Further, all examples will ignore possible transfer in contemplation of death issues. See I.R.C. § 2035.

5. See Berall, note 2 *supra*.

6. Under our progressive federal estate tax system the aggregate tax on the estates of the husband and wife, if equal in size, is much less than if one estate (usually the husband's) has all the wealth and pays all the estate tax. See Cornfeld, *Interspousal Planning After the Tax Reform Act* in TWELFTH ANNUAL INSTITUTE ON ESTATE PLANNING ¶ 400 (1978) [hereinafter cited as Cornfeld]. Ideally, the husband should transfer wealth from his estate to that of the wife to equalize the estates and circumvent the adverse consequences of the progressive estate tax rate schedule.

The amount to be transferred by the husband to the wife equals $\frac{1}{2}$ (Husband's and wife's estate) - wife's estate. Thus, if husband has \$800,000 in assets and wife owns \$200,000 worth of property then \$300,000 must be shifted over to the wife to equalize the two estates. See Anderson, *Planning for Maximum Estate Tax Marital Deduction Benefit in P-H TAX IDEAS* ¶ 13,013.2 (1978) [hereinafter cited as Anderson].

7. See S. REP. NO. 1013, 80th Cong., 2d Sess. pt. 1, at 26 (1948).

8. See JOINT COMM. ON TAXATION, GENERAL EXPLANATIONS OF THE TAX REFORM ACT OF 1976, H.R. Doc. No. 10612, 94th Cong., 2d Sess. 532 (1976) [hereinafter cited as H.R. Doc. No. 10612] (reprinted in 1976-3 C.B. 1).

ral until the death of the surviving spouse. However, it is a secondary effect which makes the deduction such a valuable planning tool: The marital deduction permits some genuine tax reduction for the combined estates of both spouses.⁹ This comment will explore the methods by which the marital deduction can be used to minimize taxes while allowing the decedent to pass as much property as possible to his chosen recipients.

C. General Description

Pre-Tax Reform Act of 1976

For taxpayers dying before 1977 the estate tax marital deduction was confined to the lesser of the value of qualifying property interests passing to a surviving spouse from the decedent or fifty percent of the decedent's "adjusted gross estate."¹⁰ Although property was part of the decedent's adjusted gross estate it did not automatically qualify for the marital deduction. For example, if husband bequeathed a life estate interest to his wife coupled with a special power of appointment, exercisable upon her death, the property subject to the special power was ineligible for the marital deduction. The requirement that such property must be included in the estate of the surviving spouse upon her subsequent death had been violated. The property subject to the special power failed to "pass" to the surviving spouse,¹¹ and was also a terminable interest. A special

9. See Schlesinger, *supra* note 4, at 1009.

10. I.R.C. § 2056(c)(1), as amended by The Tax Reform Act of 1977, Pub. L. No. 94-455, § 2002(a). The total gross estate less debts, claims, administration expenses, and losses incurred during settlement of the estate make up the "adjusted gross estate." I.R.C. § 2056(c)(2).

11. I.R.C. § 2056(a) requires that property pass to the surviving spouse from the decedent and I.R.C. § 2056(d) declares:

[A]n interest in property shall be considered as passing from the decedent to any person if and only if —

- (1) such interest is bequeathed or devised to such person by the decedent;
- (2) such interest is inherited by such person from the decedent;
- (3) such interest is the dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent;
- (4) such interest has been transferred to such person by the decedent at any time;
- (5) such interest was, at the time of the decedent's death, held by such person and the decedent (or by them and any other person) in joint ownership with right of survivorship;
- (6) the decedent has a power (either alone or in conjunction with any person) to appoint such interest and if he appoints or has appointed such interest to such person,

power of appointment in property is a terminable interest because it terminates on the lapse, or failure to occur, of some event or contingency.¹² If the wife failed to exercise her special power of appointment the property would not pass to her or to her estate, but would pass either under her residuary clause or a takers in default clause contained in the husband's will. The Code specifically denied a marital deduction if the decedent transferred this type of terminable interest to the surviving spouse.¹³

If a terminable interest was a "deductible" terminable interest, however, it could qualify for the marital deduction regardless of its characterization as a terminable interest.¹⁴ If another interest in the same property passed from the decedent to some individual, in addition to the surviving spouse, and if by reason of its passing, that other person may or would possess a portion of the property after the termination or failure of the spouse's interest, it was a nondeductible terminable interest. A devise of real estate to wife for life with the remainder to "A and his heirs" was a non-deductible terminable interest; similarly, the prior example of a decedent granting the surviving spouse a life estate with a special power to appoint the remainder by will failed to trigger the marital deduction.¹⁵

If the husband bequeathed to the wife a life estate coupled with a general power to appoint the remainder, whether inter vivos or testamentary, then the terminable interest rule problems were successfully avoided. The entire interest passed to the wife and was subject to estate tax upon her death. Such a "powers of appointment trust" became the most important method of achieving the estate tax marital deduction. However, failure to strictly comply

or if such person takes such interest in default on the release or nonexercise of such power; or

(7) such interest consists of proceeds of insurance on the life of the decedent receivable by such person. . . .

If the wife elects under local law to take against the will, only the property interest to which she is entitled under state law is considered to have "passed" to her. Similarly, if a bona fide will contest arises, whatever the wife receives qualifies for the marital deduction and any property interest surrendered is ineligible. See Treas. Reg. § 20.2056(3) - (2)(d)(2) (1958).

12. I.R.C. § 2056(b)(1)(A) and (B).

13. I.R.C. § 2056(b). References in the text to the "Code" mean the Internal Revenue Code.

14. If husband owned a patent and bequeathed it to his wife, the fair market value of the patent qualifies for the marital deduction although the patent itself will eventually terminate upon the lapse of time. Other examples of terminable interests in property qualifying for the marital deduction are contained in Treas. Reg. § 20.2056(b) - 1 (1958).

15. See Treas. Reg. § 20.2056 - 1(g), examples 1 and 3 (1958).

with the various rules of this exception often meant complete disallowance of the marital deduction.¹⁶ If Congress had merely enacted the estate tax marital deduction, parity would have existed only between community property and common law taxpayers for testamentary transfers. To equalize the tax treatment of lifetime transfers, the Code was amended to allow a fifty percent gift tax marital deduction for interspousal gifts.¹⁷

Prior to the 1976 Act, lifetime and testamentary transfers were taxed in distinctly different ways. Inter vivos gifts were subject to gift taxes at three-fourths the rate of estate taxes that would be imposed if the same property were transferred at death. Lifetime transfers were disregarded in determining taxes which were payable; further the estate and gift taxes were subject to different exemptions and separate rate schedules. Additionally, the gift taxes paid on previous lifetime gifts were ignored in calculating the gift and estate tax bases. When a gift was completed, the estate tax base excluded the gift tax which was paid; this payment of the gift tax decreased the size of the donor's estate. Yet, if the property given as a gift were retained until death, the estate tax base included the full value of the property. This discrepancy in computation of the tax base of the two transfer taxes encouraged the transfer of wealth by inter vivos gift.¹⁸

2. *Post Tax Reform Act of 1976*

Ideally, the taxes imposed on transfers of the same amount of property should be essentially the same, regardless of whether the transfer was made inter vivos or at death. Moreover, significant lifetime transfers, as a practical matter, are utilized only by the rich. Those who hold only small or moderate wealth must keep their property until death in order to guarantee financial security during their lifetimes.¹⁹ Congress attempted to reduce the tax disparity between lifetime and testamentary transfers by unifying the gift and estate tax systems. The Tax Reform Act of 1976 adopts a single,

16. See Cornfeld, *supra* note 6, at ¶ 408.2. Indeed, few sections of the estate tax laws have been the subject of as much IRS interpretation and court litigations as I.R.C. § 2056. The powers of appointment trust and related methods of achieving the marital deduction are discussed at notes 55-61 and accompanying text *infra*.

17. I.R.C. § 2523(a).

18. H.R. Doc. No. 10612, *supra* note 8, at 526.

19. *Id.* at 526-27.

unified credit for both gift and estate tax purposes, and provides for a unified rate schedule. This progressive transfer tax rate structure is based on cumulative lifetime and testamentary transfers.²⁰

The fifty percent gift tax marital deduction was restructured to allow an unlimited marital deduction for the first \$100,000 of inter-spousal gifts made after 1976. Gifts to a spouse between \$100,000 and \$200,000 yield no deduction, and for those over \$200,000, the allowable marital deduction is one-half the value of the gift.²¹

Consistent with the philosophy of a single unified transfer tax system, if a gift tax marital deduction is allowed for post-1976 gifts, then the maximum estate tax marital deduction is reduced to the extent that the gift tax marital deduction exceeds the deduction that would have been allowed if the gift tax marital deduction had remained at the pre-1976 level, a flat fifty percent rate. For lifetime gifts by a taxpayer to his spouse of less than \$200,000, the net effect of the new law is to reduce the estate tax marital deduction by the amount that the lifetime deduction claimed exceeds fifty percent of the marital gifts. If, for example, a husband made a \$100,000 gift to his wife, and claimed a \$100,000 gift tax marital deduction, the estate marital deduction is reduced by \$50,000.²²

Perhaps the change producing the most dramatic effect on estate planning is the expansion of the estate tax marital deduction for the estates of individuals dying after 1976. Presently, the deduction is the greater of one-half of decedent's adjusted gross estate or \$250,000.²³ Congress revised the marital deduction so that taxpayers with small and medium sized estates can leave a minimum amount of property to the surviving spouse without incurring estate tax.²⁴ The 1976 changes represent a departure from the original objective

20. *Id.* at 526, Berall, *supra* note 2, at 34.

21. I.R.C. § 2523(a).

22. See Madden, *Is the Living Gift Really Dead?*, 56 TAXES 435, 436 (1978), citing I.R.C. § 2056(c)(1)(B), as amended by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(a) [hereinafter cited as Madden]. See also Capouano and Rinsky, *Planning Gifts to a Spouse to Obtain Maximum Tax Benefits Under the New Law*, 46 J. TAX, 73, 77 [hereinafter cited as Capouano & Rinsky]; Cole, *Estate Planning and the Tax Reform Act of 1976 — Inter Vivos Gifts, Property Ownership and Planning for the Marital Deduction*, 25 U. KAN. L. REV. 327, 342 (1977) [hereinafter cited as Cole]. For inter vivos gifts over \$200,000 the gift tax marital deduction is fifty percent of the value of the gift, so adjustment to the estate tax marital deduction is not required.

23. I.R.C. § 2056(c)(1)(A), as amended by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(a).

24. H.R. Doc. No. 10612, note 8 *supra*.

to equalize the tax treatment of community property and common law states.²⁵ Other Code concepts affecting the estate marital deduction, such as adjusted gross estate and the terminable interest rule, were left intact.²⁶

II. PLANNING CONSIDERATIONS

A. *When to Use the Marital Deduction*

Although the 1976 reforms have been characterized as favorable to taxpayers, automatic use of the marital deduction is not always to the taxpayer's advantage. If the estate is not taxable due to allowable deductions, credits, and exemptions, the decedent should capitalize on this opportunity and make tax free transfers to other secondary beneficiaries.

Use of the new \$250,000 maximum marital deduction, combined with the exemption equivalent to the unified credit, (assuming no reduction of either for lifetime transfers) will entirely avoid estate taxes for adjusted gross estates of the following amounts:²⁷

TABLE ONE

For Deaths In:	Unified Credit Exemption Equivalent	+	Marital Deduction	=	Adjusted Gross Estate
1977	\$120,667		\$250,000		\$370,677
1978	\$134,000		\$250,000		\$384,000
1979	\$145,333		\$250,000		\$397,333
1980	\$161,563		\$250,000		\$411,563
1981 & Thereafter	\$175,625		\$250,000		\$425,625

Assuming that the wife is adequately provided for irrespective of the will, or has assets of her own, transfers to the surviving spouse will only increase the size of her taxable estate.²⁸

25. See notes 2-8 and accompanying text *supra*.

26. See notes 10-16 and accompanying text *supra*.

27. See Berall, *supra* note 2, at 34. For the sake of convenience, state inheritance taxes will be ignored in all examples.

28. See Anderson, note 6 *supra*.

If the husband's estate is slightly greater than the allowable exemptions and deductions, transfers directly to secondary beneficiaries will result in a tax which could be eliminated through use of the marital deduction. For example, assume decedent died in 1981 with a \$275,000 gross estate and an adjusted gross estate of \$250,000 following payment of administration expenses. The unified credit would cut the tax bill of a \$250,000 bequest to his children by \$47,000, from \$70,000 to \$23,000. Yet, a bequest of the entire estate to the surviving spouse would result in no tax since the entire transfer would be eligible for the marital deduction.²⁹ However, the marital deduction should not be used where the exemption equivalent exceeds the adjusted gross estate, since under the unified credit, with its higher exemption equivalent, there will be no tax at the first spouse's death.

In addition to the new unified credit, the interrelationship between the gift and estate tax marital deductions has also been revised and must carefully be considered by the estate planner. If the will declares the wife is to receive "fifty percent of the adjusted gross estate", rather than "maximum marital deduction allowable," an overfunding of the estate tax marital deduction is possible if there were interspousal gifts. The fifty percent provision fails to provide for the reduction in the estate tax marital deduction required for the excess of the donor's lifetime marital deduction over one-half of the value of the interspousal gifts. A decedent (with a \$1,000,000 adjusted gross estate) who purported to pass fifty percent to his wife through an estate tax marital deduction must reduce the deduction by \$50,000 if he made lifetime interspousal gifts amounting to \$100,000. Thus, any clause transferring "fifty percent of the adjusted gross estate" to the wife should automatically be readjusted for possible lifetime interspousal gifts.³⁰

Use of the new \$250,000 maximum estate tax marital deduction may result in overfunding of the marital deduction and payment of substantially more aggregate estate taxes. If a decedent dying in 1981 desired to exploit the new \$250,000 deduction and, for that purpose, left his wife an amount equal to "the maximum marital

29. See *id.* Although there is no tax upon the husband's death, the wife must pay tax on the property transferred upon her later death. See note 8 and accompanying text *supra*.

30. See note 22 and accompanying text *supra*. Use of a minimum marital deduction clause or disclaimer could possibly avoid this particular overfunding problem. See text accompanying notes 95-99 *infra*.

deduction allowed for federal estate tax purposes,"³¹ and had made no interspousal gifts, then the federal estate tax liability would be as follows:

TABLE TWO

	50% of Adjusted Gross Estate	Maximum Marital Deduction
Adjusted Gross Estate	\$351,250	\$351,250
Less Marital Deduction	<u>\$175,625</u>	<u>\$250,000</u>
Taxable Estate and Transfer Tax Base	\$175,625	\$101,250
Tentative Tax	\$47,000	\$36,000
Less Unified Credit	<u>\$47,000</u>	<u>\$47,000</u>
Estate Tax Liability	-0-	-0-

If the surviving spouse did not dissipate the funds received at her husband's death, upon her death estate taxes would be as follows:

TABLE THREE

	50% of Adjusted Gross Estate	Maximum Marital Deduction
Adjusted Gross Estate	\$175,625	\$250,000
Less Adjusted Taxable Gifts	<u>-0-</u>	<u>-0-</u>
Taxable Estate and Transfer Tax Base	\$175,625	\$250,000
Tentative Tax	\$47,000	\$70,800
Less Unified Credit	<u>\$47,000</u>	<u>\$47,000</u>
Estate Tax Liability	-0-	\$23,800

31. If a client with a pre-1977 will providing for the "maximum marital deduction," died in 1977 or 1978, the \$250,000 maximum would be unavailable. With the exceptions, the maximum marital deduction during this transitional period for pre-1976 wills was fifty percent of the adjusted gross estate. If such a will was amended after 1976 or a state adopted

Although use of the \$250,000 maximum marital deduction reduced the tax due on the estate of the husband, the wife's estate taxes were substantially increased. If the husband had bequeathed only one-half of his estate to the surviving spouse, neither estate would have incurred estate tax liability, since both would have wealth roughly equal to the \$175,625 exemption equivalent of the unified credit.³²

Taxpayers dying after 1980 with estates exceeding \$175,625 but less than \$425,625,³³ and wills providing for use of the \$250,000 maximum marital deduction will increase the combined estate tax liability of the husband and wife, although deferring payment of taxes, until the death of the surviving spouse.³⁴ However, use of the \$250,000 deduction by taxpayers with estates in the \$425,000 to \$500,000 range, can result in genuine deferral of estate taxes without an increase in the total estate tax liability of the individual spouses. If the husband died in 1981, without having made any inter vivos gifts to his wife, estate taxes would be as follows:

TABLE FOUR

	50% of Adjusted Gross Estate	Maximum Marital Deduction
Adjusted Gross Estate	\$450,000	\$450,000
Less Marital Deduction	\$225,000	\$250,000
Taxable Estate and Transfer Tax Base	\$225,000	\$200,000
Tentative Tax	\$62,800	\$54,800
Less Unified Credit	\$47,000	\$47,000
Estate Tax Liability	\$15,800	\$7,800

legislation providing that such pre-1977 maximum marital deduction formulas are to be interpreted to yield the higher \$250,000 limit, then the new \$250,000 maximum marital deduction applied. These transitional rules are inapplicable for decedents dying after 1978. H.R. Doc. No. 10612, *supra* note 8, at 533.

32. See Capouano & Rinsky, *supra* note 22, at 74-75.

33. See note 27 and accompanying text *supra*.

34. See Capouano & Rinsky, *supra* note 22, at 74-75.

If the surviving spouse does not dissipate the funds received at her husband's death, estate taxes would be:

TABLE FIVE

	50% of Adjusted Gross Estate	Maximum Marital Deduction
Adjusted Gross Estate	\$225,000	\$250,000
Less Adjusted Taxable Gifts	-0-	-0-
Taxable Estate and Transfer Tax Base	\$225,000	\$250,000
Tentative Tax	\$62,800	\$70,800
Less Unified Credit	\$47,000	\$47,000
Estate Tax Liability	\$15,800	\$23,800

Under either alternative, the combined estate tax liability is the same: \$31,600. Use of the new \$250,000 maximum estate tax marital deduction, as opposed to a straight 50 percent formula, means that \$8,000 in estate taxes can be deferred until the death of the wife.³⁵

For estates over \$500,000, the \$250,000 maximum marital deduction option is less than the marital deduction measured by one-half the adjusted gross estate. Hence, the change in the estate tax marital deduction from one-half of the adjusted gross estate to the greater of one-half of the adjusted gross estate or \$250,000, results in no genuine tax benefits for estates in excess of \$500,000.³⁶

However, the new law will have a pronounced effect on larger estates due to changes in the interrelationship between the marital deduction and inter vivos gifts. After 1980, a taxpayer will be able to transfer a \$601,250³⁷ estate to his spouse without incurring any tax liability:

35. See *id.* at 75. Cf. Berall, *supra* note 2, at 34 (formula revisions must be made to obtain the maximum marital deduction for adjusted gross estates in the \$425,625 to \$500,000 range). The number of estates with between \$425,625 and \$500,000 in assets is so small that the overall utility of the new \$250,000 limitation is questionable.

36. See Capouano & Rinsky, *supra* note 22, at 75.

37. Under the Revenue Act of 1978, the maximum estate tax marital deduction will not

TABLE SIX

Husband's Gross Estate	\$601,250
Intervivos Gifts to Wife in 1981	\$351,250
Gift Tax Marital Deduction:	\$175,625
First \$100,000	\$100,000
Half of Gifts	
Exceeding \$200,000	\$75,725
Taxable Gifts	\$175,625
Tentative Tax	\$47,000
Less Unified Credit	\$47,000
Gift Tax Liability	-0-
Adjusted Gross Estate at Death in 1981	\$250,000
Less Estate Tax Marital Deduction	\$250,000
Taxable Estate	-0-
Plus Adjusted Taxable Gifts	\$175,625
Transfer Tax Base	\$175,625
Less Unified Credit	\$47,000
Estate Tax Liability	-0-

If the surviving spouse does not dissipate the funds received at her husband's death, upon her death her estate taxes would be:

TABLE SEVEN

Adjusted Gross Estate	\$601,250
Less Adjusted Taxable Gifts	-0-
Taxable Estate and Transfer Tax Base	\$601,250

be adjusted for lifetime gifts not necessitating the filing of a gift tax return. Thus, annual interspousal gifts of \$3,000 or less will not affect the cut-down. *See* 47 FED. TAXES (P-H) 206 (1978), *citing* the Revenue Act of 1978, H.R. 13511, § 702(g)(1) and (2), *amending* I.R.C. § 2056(c)(1)(B).

Tentative Tax	\$193,262
Less Unified Credit	\$47,000
Estate Tax Liability	\$146,262

Although the husband's property escapes taxation, this strategy represents poor tax planning since when the wife dies her estate incurs a sizeable \$146,262 tax.³⁸ Thus the practitioner should seek not only to minimize the tax due on the death of the first spouse, but also to decrease the total estate taxes payable by both spouses to the smallest amount possible.³⁹ A strategy more in accord with this objective is illustrated as follows:

TABLE EIGHT

Husband's Adjusted Gross Estate at Death in 1984	\$601,250
Less Estate Tax Marital Deduction	\$300,625
Taxable Estate	\$300,625
Plus Adjusted Taxable Gifts	-0-
Transfer Tax Base	\$300,625
Tentative Tax	\$89,531
Less Unified Credit	\$47,000
Husband's Estate Tax Liability	\$42,531
Wife's Adjusted Gross Estate	\$300,625
Less Adjusted Taxable Gifts	-0-
Taxable Estate and Transfer Tax Base	\$300,625
Tentative Tax	\$84,531
Less Unified Credit	\$47,000
Wife's Estate Tax Liability	\$37,531

38. See Capouano & Rinsky, *supra* note 22, at 74.

39. See *id.*

Instead of making inter vivos gifts to his spouse, the husband used the marital deduction to pass one-half of his \$601,250 estate to his wife with the remaining one-half passing (net after estate taxes paid) to a residuary trust of which the wife is the income beneficiary.⁴⁰ Thus, proper use of the gift and estate tax marital deductions, along with the unified credit, allows for deferral of \$37,531 in estate taxes until the death of the surviving spouse. Moreover, by equalizing the estates, aggregate estate taxes are reduced from \$146,262 to \$85,062, representing a savings of \$61,200.⁴¹

The tax savings achieved by estate splitting may be undesirable when certain non-tax factors are considered. If the wife needs the bulk of the funds from her deceased husband's estate for living expenses or to support and educate the children, the decision to opt for maximum tax deferral, at the cost of additional tax on the death of the wife, may be compelled.⁴² Moreover, if the wife is quite young and there is a high probability that she will outlive her husband by a substantial length of time, then the use of the deferred tax savings for this span of years may justify incurring more aggregate tax when the wife eventually dies. However, except in limited instances such as these, a decision to avoid taxation of the husband's property, at the expense of greater combined taxes when the surviving spouse subsequently passes away, appears indefensible.⁴³

B. *Inter Vivos Gifts as an Estate Equalizer*

Another way to achieve the objective of equalizing the estates of the husband and wife is through careful use of inter vivos gifts. Interspousal transfers are especially advantageous where the husband has a large estate and the wife has limited or no independent wealth. In such instances inter vivos gifts can be a hedge against the wife predeceasing the husband. The husband can transfer property which is eligible for the gift tax marital deduction, or which qualifies for tax exclusion, to the wife to augment her estate to, at least, the exemption equivalent of the unified credit. This prevents loss of the

40. Such a trust arrangement as a method to secure the marital deduction is discussed at notes 62-63 and accompanying text *infra*.

41. See Capouano & Rinsky, *supra* note 22, at 73-74; Goldstein & Coleman, *Gifts to a Spouse*, 177 N.Y.L.J. 1 (February 28, 1977) [hereinafter cited as Goldstein & Coleman].

42. See Capouano & Rinsky, *supra* note 22, at 73-74.

43. See Goldstein & Coleman, note 41 *supra*.

unified credit should the wife predecease the husband. Ideally, the gifts will be excluded from the donor-husband's estate tax base.⁴⁴

If a gift tax marital deduction is claimed for interspousal transfers exceeding \$100,000 these "adjusted taxable gifts" are added to the donor-husband's estate tax base. The effect will be a progressive increase in the husband's estate tax if he should predecease his wife.⁴⁵ Thus use of the gift tax marital deduction for gifts over \$103,000⁴⁶ will raise the combined estate taxes dramatically only if the husband predeceases the wife.⁴⁷

Assume a husband has \$400,000 and wife has no assets. In an attempt to prevent loss of her unified credit and to lessen the overall tax burden, the husband makes gifts as indicated below and claims a gift tax marital deduction. Unfortunately, he predeceases his wife more than three years after making the gifts.⁴⁸

TABLE NINE

	Gift of \$103,000	Gift of \$175,625
Husband's Gross Estate	\$297,000	\$224,625
Less Maximum Marital Deduction	\$201,500	\$224,375
Taxable Estate	\$95,500	-0-
Adjusted Taxable Gifts	-0-	\$72,625
Transfer Tax Base	\$95,500	\$72,625
Estate Tax Liability— Net of Unified Credit	-0-	-0-
Wife's Transfer Tax Base	\$304,500	\$400,000
Estate Tax Liability	\$42,330	\$74,800
Combined Estate and Gift Tax Liability	\$42,330	\$74,800

44. See Lerner, *Spouse to Spouse — The Gift and Estate Tax Marital Deduction*, in 1 NYU THIRTY-SIXTH ANNUAL INSTITUTE ON FEDERAL TAXATION 155, 168-69 (1978) [hereinafter cited as Lerner]. See also Cornfeld, *supra* note 6, at ¶ 406; and Berall, *supra* note 2, at 33.

45. See Lerner, *supra* note 44, at 169; Cornfeld, *supra* note 6, at ¶ 406.

46. Use of a figure of \$103,000 instead of a gift of \$100,000 reflects the change wrought by The Revenue Act of 1978. See note 37 *supra*.

47. See Lerner, *supra* note 44, at 169-70. See also Goldstein & Coleman, note 41 *supra*.

48. See Cornfeld, *supra* note 6, at ¶ 405; and Madden, *supra* note 22, at 437.

By attempting to pass enough property to his wife so as to protect all of her unified credit, the husband actually raised their combined estate and gift taxes.

Despite the potential hazards associated with an interspousal gift-giving plan, there are numerous advantages to be had by instituting such a program early in life and continuing it for an extended period of time:

1. *Removal of Later Appreciation from Donor's Estate*

If husband makes an inter vivos transfer of a \$100,000 asset to his wife it may well be worth \$200,000 at husband's death. Even if the property were an adjusted taxable gift, thus includible in computing the husband's estate tax base, the appreciation escapes taxation upon the donor-husband's death. The gift is brought back into the estate at the value when it was made and the related gift tax return filed.⁴⁹

2. *Decrease in Donor's Income Tax*

Transfers by gift of income producing assets shift the income from the transferred assets away from the husband. Additionally, the income does not accumulate and thereby increases the size of the donor's estate.

3. *Removal of Gift Taxes Paid from the Estate*

Gift taxes paid on post-1976 transfers of property after 1976 will not be included in the gross estate of the donor, but will be credited against the tax due on the donor's estate.⁵⁰ In contrast, estate taxes payable upon the donor's death are not deducted when computing gross estate. As a result, the gift taxes paid under an intensive gift-giving program reduce the size of the donor-husband's gross estate and his ultimate estate tax liability.⁵¹

In addition to the possibility of marital deduction difficulties as illustrated above, other practical problems should be evaluated be-

49. I.R.C. § 2001(b)(2), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(1).

50. See Madden, *supra* note 22, at 438-39.

51. See *id.* at 439.

fore advising a client to embark on an inter vivos gift-giving program:

a. Inability to Pay Gift Taxes

Even if the donor has enough wealth to mount an extended interspousal transfer plan, he may lack the liquidity necessary to pay the gift taxes due on large gifts to his wife. Moreover, substantial taxable gifts may wreak havoc on the donor's own estate plan if currently existing liquid assets are drained away by steep gift tax payments.⁵²

b. Hesitancy to Use Unified Estate and Gift Tax Credit

Although the gift tax marital deduction may be used to avoid the payment of gift taxes in interspousal transfers, the penalty extracted by the Code is the nonavailability of the unified credit when the husband dies. Technically, the credit is not depleted by the making of lifetime gifts; rather adjusted taxable gifts made after 1976 are added back into the taxable estate, thereby nullifying the utility of the unified credit and progressively increasing estate taxes.⁵³ If the planner anticipates a critical liquidity shortage when the husband dies this elimination of the credit will only aggravate the dilemma, especially if liquid assets were used to pay the gift taxes on transfers exceeding the \$100,000 gift tax marital deduction.⁵⁴

III. METHODS OF OBTAINING THE MARITAL DEDUCTION

A. Outright Bequest to the Surviving Spouse

An outright transfer of property to the wife is the simplest way to qualify for the marital deduction. The decision to make such a bequest to the surviving spouse should be influenced by the business and investment ability of the wife to manage the property. The age, health, and temperament of the wife may hinder her attempts to objectively oversee the husband's property. If the size of the estate

52. See *id.* at 440 n.24.

53. See *id.* at 440-41. Investment type assets such as stock and real property are better objects of a gift-giving plan since liquid assets may be required for the donor-husband's own estate planning purposes. See *id.* at 438.

54. See Cornfeld, *supra* note 6, at ¶ 408.1.

justifies both the expense and administrative complexities of trust management, putting the marital bequest into a trust, managed by a professional trustee, is the more advisable course of action.⁵⁵

B. Transfers in Trust for the Surviving Spouse

1. Powers of Appointment Trust

Since the inception of the marital deduction, the powers of appointment trust has proven to be the most popular alternative to the specific bequest method of securing a marital deduction.⁵⁶ The surviving spouse must be entitled to all income from the entire interest, or from a specific portion of the trust corpus. Income must be paid to the spouse at least annually. In addition, the wife must have the power to appoint the entire interest or a specific portion thereof, to herself or her estate. The power must be exercisable either by an inter vivos act or at death by will, and the wife's interest or power is to be free of any conditions or powers held by others.⁵⁷

2. Marital Deduction Estate Trust

Occasionally, the estate trust may prove more advantageous to use than the powers of appointment trust. Both trust devices transfer an income interest in the marital deduction trust to the wife. Similarly, the income interest terminates at the end of a specified term of years or when the wife dies. All remaining trust corpus and accumulated income will then pass to the wife or her estate to ensure qualification for the marital deduction.

The estate trust is exempt from the strict technical requirements of the powers of appointment trust. Thus income can be accumulated or distributed in the discretion of the trustee in order to maximize tax benefits. This is most advantageous where the surviving spouse is in a high income tax bracket due to significant income from earnings or other sources. Under such circumstances the trustee will refrain from making distributions until the wife's income

55. See *id.* at ¶ 408.2.

56. Although mentioned earlier as a caveat to the planner, it is worth repeating that strict adherence with the Code is required for such a transaction to qualify for the marital deduction. See note 16 and accompanying text *supra*.

57. Treas. Reg. § 20.2056(b) - 5(a)(1) (1958).

decreases or she dies.⁵⁸

If the fiduciary opts against making inter vivos distributions to the wife, such accumulations, when finally distributed to her estate, are subject to the "throwback rules" with their attendant tax penalties and burdensome record keeping provisions. The throwback rules are triggered because this is an accumulation distribution.⁵⁹ The failure to make lifetime distributions requires the same property to be probated again at the death of the surviving spouse and will be subject to additional court costs, attorney's and executor's fees, and claims of creditors.⁶⁰ Further, since income is paid at the discretion of the fiduciary, the surviving spouse lacks the income security provided by a powers of appointment trust which must annually distribute income.

IV. POSSIBLE MARITAL DEDUCTION ARRANGEMENTS

A. Basic Structure

Both the estate and powers of appointment trust are premised upon the same basic foundation. One-half of the husband-decedent's adjusted gross estate passes to the surviving spouse, either as an outright bequest or through a marital deduction trust. The remainder of the husband's estate goes to a family or residuary trust for the benefit of the wife and children. The family trust property is excluded from the gross estate of the wife, except for the amount of the corpus drawn down by her in the year immediately preceding her death.⁶¹ Residuary trust distributions made to the wife in prior years were used to meet living expenses. Thus this

58. See Cornfeld, *supra* note 6, at ¶ 408.3. The estate trust can be characterized as a terminable interest since the wife has no inter vivos power to invade the corpus and cannot compel the trustee to make income distributions to her. Even if depicted as a terminable interest, this is a deductible terminable interest for all accumulated income and corpus "pass" to the wife upon expiration of the specified term of years or to her estate when she dies. See note 14 and accompanying text *supra*.

59. See Cornfeld, *supra* note 6, at ¶ 408.3. The throwback rules are designed to prevent the trustee from making distributions only in years when the beneficiary has low income. If the estate trust distributes income to the wife which it has earned and accumulated without previously distributing, the wife must recompute her income tax for those years in which the income was accumulated by the trust just as if the trust had distributed income in the prior years rather than accumulating it. See I.R.C. § § 665 and 668.

60. See Cornfeld, *supra* note 6, at ¶ 408.3.

61. I.R.C. § 2041(b).

wealth is not considered to be part of the wife's estate. This basic structure can be tailored to give the wife substantial or limited control in both the marital deduction and residuary trust.

B. Maximum Control

Wife receives the marital deduction portion outright or in trust. If a trust is established the wife has a life estate in all of the income and has the power to appoint, either during her lifetime or at death, the corpus of the marital deduction trust. The wife has unlimited power to invade the corpus of the marital deduction trust. In the residuary trust, the wife has a life estate in all of the income, plus the power to invade the trust annually to the extent of the greater of \$5,000 or five percent of the corpus. Alternatively, the trustee has the power to invade the corpus for the wife's health, support, and maintenance.⁶²

C. Moderate Control

The wife's rights to the marital deduction portion are the same as in the above plan. However, she has no right to receive any income or corpus from the residuary trust until the entire marital deduction trust is depleted. This arrangement is termed a vanishing marital trust.

Analogous to the vanishing marital trust is the lapsing power of appointment trust. Wife has no rights in the residuary trust until most of the marital deduction portion is expended. At that point wife begins receiving income from the residuary trust plus the right to draw down the greater of \$5,000 or five percent of the corpus per year; if she so elects.⁶³

D. Less Control

Although wife's rights in the marital deduction portion are identical to the previous examples, she has no right to receive any income

62. These limitations on the wife's ability to invade the corpus of the residuary trust will prevent corpus encroachments elected by the widow, or received from the trustee, in prior years from being taxable in her estate. I.R.C. § § 2041(b)(1)(a) and (b)(2). See also Treas. Reg. § § 20.2041-1(c)(1)(ii); (c)(2), and 20.2041-3(d)(3) (1958).

63. See note 62 and accompanying text *supra*.

or corpus from the residuary trust. This is a departure from the typical marital and family trust arrangement.

E. Least Amount of Control

If an estate trust is used, the trustee has the discretion to distribute or accumulate income earned by the marital deduction trust. The wife has no power to appoint the corpus of the marital deduction trust during her lifetime. To ensure the marital deduction, all accumulations, if any, plus the corpus, pass at death to her estate. To further constrict the wife's control over her deceased husband's assets the surviving spouse has absolutely no rights or interest in the residuary trust.

V. MARITAL DEDUCTION FORMULA CLAUSES

A. Introduction

After the marital deduction was enacted, it was necessary to devise a method to pass only a sufficient amount of property to qualify for the maximum marital deduction. Fixed dollar bequests cannot meet this objective because rarely, if ever, will a testator be able to accurately predict the ultimate size of his estate at death. There is always the chance that the dollar amount selected will be less than one-half of the adjusted gross estate, the maximum marital deduction. This would subject the husband's estate to more tax than necessary. On the other hand, if too much property were bequeathed to the wife such overfunding of the marital deduction would subject the estate of the surviving spouse to excess taxes.

"Formula bequests" to circumvent over an under-funding of the marital deduction were devised to transfer only enough property to the surviving spouse to ensure the maximum marital deduction. Formula bequests are designed to pass to the surviving spouse only the amount necessary to eliminate the tax in the estate of the first spouse to die. Factors such as insurance proceeds and jointly owned property passing to the wife outside of the will are considered; the estimated amount of the testator's estate as well as property values and estate and inheritance taxes are also estimated.

The formula bequest must coordinate a marital deduction with new concepts introduced by The Tax Reform Act of 1976, such as

increased amounts sheltered from estate tax by the unified credit,⁶⁴ qualified disclaimers,⁶⁵ carryover basis,⁶⁶ and the generation skipping transfer tax.⁶⁷

B. Types of Formula Bequests

1. Fractional Share (Share of the Residue) Formula

Use of a fractional share formula indicates the surviving spouse is given a fractional share, or percentage of a described fund, which is generally the residuary estate.⁶⁸ Even if there are marked changes in the size of the testator's estate before distribution, the maximum marital deduction is assured. Any depreciation or appreciation in the value of the estate occurring between the time of death and the date of distribution is proportionately shared by the surviving spouse and the residuary beneficiaries.

The need to fractionalize *every* asset in the estate according to the fraction makes use of the fractional share formula impractical for a wide range of assets, most notably real property interests. Assets must be valued at least three separate times: on the date of death, the alternate valuation date, and again on the date of distribution. On each occasion the fraction must be recomputed. If the wife attempts to exchange fractional interests in certain assets with residuary beneficiaries, in order to acquire a complete ownership interest, a taxable exchange requiring recognition of gain or loss has occurred. Fractional share bequests fail to protect the surviving spouse against a precipitous decrease in the value of the residuary estate between the time of death and the date of distribution.⁶⁹

64. See note 20 and accompanying text *supra*.

65. See notes 95-99 and accompanying text *infra*.

66. See notes 114-119 and accompanying text *infra*.

67. See notes 100-109 and accompanying text *infra*.

68. See Lerner, *supra* note 44, at 172-73. A typical fractional share formula would provide:

The Marital Trust shall consist of the greater of \$250,000 or the following fraction of my residuary estate; (a) the numerator shall, when added to the aggregate amount of all property in my gross estate not passing under this Article for which a marital deduction is allowable, equal one-half ($\frac{1}{2}$) of my adjusted gross estate; and (b) the denominator shall equal the value of my residuary estate for Federal estate tax purposes.

See Kabaker, *Drafting Post-1976 Marital Deduction Formula Clauses*, in TWELFTH ANNUAL INSTITUTE ON ESTATE PLANNING ¶ 1204.3 (1978) [hereinafter cited as Kabaker].

69. See Kabaker, *supra* note 68 at ¶ 1212.1 - .2; Lerner, *supra* note 44, at 172-73.

2. *Pecuniary Formula*

As the name implies, the pecuniary formula yields, to the wife, a bequest of a specific dollar amount, which is usually equal to the greater of \$250,000 or one-half of decedent's adjusted gross estate. If a pecuniary bequest is satisfied by an "in kind" distribution, the market price as of the date of distribution is the value used.⁷⁰

Like the fractional share formula, the pecuniary bequest formula ensures the maximum marital deduction even with fluctuations in the size of the estate before the date of distribution. The executor has the advantage of being able to choose particular assets to fund the marital bequest. Thus a pecuniary bequest can be satisfied with fewer assets in a rising market. Pecuniary formulas also place a ceiling on the value of property transferred to the wife, for the dollar amount never fluctuates as property values constantly change.

If the executor uses low basis assets to satisfy a pecuniary formula bequest, the post-death appreciation must be recognized by the estate at the distribution date.⁷¹ The surviving spouse will be disadvantaged by the decedent's attempts to guarantee her a fixed dollar bequest, for only the residuary beneficiaries will be able to share in any appreciation of the estate occurring between the date of death and the date of distribution. However, if the assets decrease markedly in value the loss is shifted to the non-marital distributees who had no assurance of receiving a fixed amount. The wife may receive a proportionally larger share of the total estate at the expense of the residuary beneficiaries, and this may be contrary to the decedent's

70. See Lerner, *supra* note 44, at 171; Cole, *supra* note 22, at 344. A standard pecuniary formula would provide:

I devise and bequeath to the Trustee hereinafter named as Trustee of the Marital Trust, property, the value of which, when added to the aggregate amount of all property in my gross estate not passing under this Article for which a marital deduction is allowable, equals in amount the greater of \$250,000 or one-half ($\frac{1}{2}$) of my adjusted gross estate. This bequest may be satisfied in cash or in kind; provided, however, that assets distributed in kind shall be valued for such purpose at their respective fair market values as of the date of distribution.

See Kabaker, *supra* note 68, at ¶ 1204.1.

71. The carryover basis rules limited the recognized gain to the differences between the date of death and the date of distribution values. I.R.C. § 1040(a), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(b). However, with the delay in the operation of the carryover basis provisions until 1980, the estate must now pay tax on the difference between the adjusted basis of the asset used to satisfy a pecuniary bequest and its date of distribution value. See the discussion of carryover basis at notes 114-117 and accompanying text *infra*.

intention. Finally, another problem with a pecuniary formula, as with the fractional share formula, is that the same assets must be valued on at least three instances: the date of death; the alternate valuation date, and the date of distribution.⁷²

3. *Revenue Procedure 64-19*

If date of distribution values are used when funding a pecuniary bequest, the estate must recognize a taxable gain whenever low basis, appreciated assets are used to satisfy the bequest. Optimal tax benefits could be enjoyed if the will provided to the fiduciary the discretion to make "in kind" distributions at federal estate tax values (date of death values). The executor would fund the marital trust with those assets which has appreciated or depreciated the most between the estate tax value date and the date of actual distribution.

For example:

TABLE TEN

Date of death or estate tax value:	
Asset Group 1	\$500,000
+ Asset Group 2	<u>\$500,000</u>
Total Distributable Estate Expressed at date of death or estate tax value	\$1,000,000
Less 50% Marital Deduction-Pecuniary Bequest	\$500,000
Date of Distribution Values:	
Asset Group 1	\$75,000
+ Asset Group 2	<u>\$625,000</u>
Total Value of Estate When Distributed	\$700,000
Values Distributed:	
To Surviving Spouse	\$75,000
+ To Residuary Beneficiaries	<u>\$625,000</u>
Total Distributed	\$700,000

72. See Kabaker, *supra* note 68, at ¶ 1212.4.

The Group 1 Assets to be taxed in the estate of the surviving spouse are minimized with little, if any, reduction in the total economic benefits to the wife who has been amply provided for outside of the will via non-marital deduction property such as terminable interests or possesses her own independent wealth.⁷³ Since estate tax values are used, the transfer of appreciated or depreciated assets does not trigger the recognition of gain or loss.

The Service successfully put an end to this scheme with Revenue Procedure 64-19,⁷⁴ which requires that pecuniary formula bequests be satisfied with property proportionately representative of the appreciation and depreciation of the value of all assets available for distribution. Thus, in the example, the wife must receive an equal share of Group 1 and Group 2 assets when her pecuniary bequest is satisfied. Consequently, the estate recognizes a loss upon the distribution of Group 1 Assets, and a gain upon the distribution of Group 2 Assets.

4. *Modified Tax Value Pecuniary Formula*

Practitioners responded to Revenue Procedure 64-19 with a hybrid formula having traits of both the pecuniary and fractional formulas. Similar to a pecuniary formula bequest, the marital deduction share is expressed as a predetermined dollar amount (usually the greater of \$250,000 or one-half of the adjusted gross estate). Yet, like fractional share formula bequests, the pecuniary formula share of the surviving spouse includes all depreciation and appreciation occurring between the date of death and the date of distribution, even though the wife's fifty percent share is based on the date of death value of decedent's estate. The modified tax-value pecuniary share formula avoids the possibility of the marital deduction bequest representing a disproportionately larger or smaller share of the estate.⁷⁵ In this formula, unlike plans using the fractional share

73. See *id.* at ¶ 1206.5.

74. 1964-1 C.B. 682. See also Kabaker, *supra* note 68, at ¶ 1206.5.

75. A basic modified tax-value formula follows:

I devise and bequeath to the Trustee hereinafter named as the Trustee of the Marital Trust, property, the value of which, when added to the aggregate amount of all property in my gross estate not passing under this Article for which a marital deduction is allowable, equals in amount the greater of \$250,000 or one-half ($\frac{1}{2}$) of my adjusted gross estate. This bequest may be satisfied in cash or in kind; provided, however, that assets distributed in kind shall be valued for such purpose at their values as finally

bequest, there is no need to allocate a fractional interest in all of the assets to the marital bequest. The fiduciary is assured of maximum flexibility in selecting the assets to be distributed. However, since this is a pecuniary-type formula, at least three or more valuations will be required.⁷⁶

5. Equalization Clauses

Because the chief aim of proper marital deduction planning is to equalize the taxable estates and estate taxes of both the husband and wife, the ideal formula clause is one that equalizes the combined taxable estates. Such an equalization clause instructs the executor to ascertain the value of *both* the estate of the decedent *and* that of the surviving spouse upon the death of the first spouse to die.⁷⁷ After deletion of property ineligible for the marital deduction, the surviving spouse is given a fractional share in the residual estate. This interest is just enough to equalize the aggregate taxable estates of the husband and wife.⁷⁸

The IRS has challenged the use of equalization clauses, contending that the resulting bequest to the wife is ineligible for the marital deduction. The IRS' position is premised upon a literal reading of the terminable interest rule.⁷⁹ If the value of the estate of the surviving spouse increased between the date of her husband's death and the alternate valuation date, while the assets owned by decedent

determined for Federal estate tax purposes. In any allocation between such trusts, the Trustee need not allocate assets pro rata, but both trusts shall share proportionately in the appreciation or depreciation, from the date of my death to the date of allocation, in the value of all assets available for allocation.

See Kabaker, *supra* note 68, at ¶ 1212.55.

76. See Cornfeld, *supra* note 6, at ¶ 1410.

77. The alternate valuation date may be substituted for the date of death for estate tax purposes. I.R.C. § 2032.

78. An equalization formula would read:

There shall be allocated to my (wife/husband) that percentage interest in the balance of the assets which shall, when taken together with all other property qualifying for the marital deduction, obtain for my estate a marital deduction which results in the lowest federal estate tax in my estate and my (wife's/husband's) estate on the assumption that my (wife/husband) dies after me but on the date of my death and that (her/his) estate was valued as of the date on (and in the manner in) which my estate is valued for Federal estate tax purposes; my purpose is to equalize, insofar as possible, my estate and (her/his) estate for federal estate tax purposes.

Kabaker, *supra* note 68, ¶ 1210.1.

79. See notes 11-16 and accompanying text *supra*.

dropped in value over the same period, the fiduciary would use the alternative valuation date to achieve the greatest tax benefit. This would serve to cut, by terminating in whole or in part, the wife's marital deduction share received from the decedent's estate. Use of an alternative valuation date to equalize the estates could potentially mean partial divestiture of the wife's marital share of her spouse's estate.⁸⁰

In *Estate of Charles W. Smith*,⁸¹ the tax court decided the validity of a marital deduction trust established pursuant to an equalization formula. The court did not view equalization clauses as creating terminable interests merely because calculation of the property passing to the surviving spouse was not made at the date of death. The bequest at issue qualified for the marital deduction, since the interest of the wife was indefeasibly vested on the date of the husband's death. The wife was entitled to the marital portion of the trust, although the exact amount of the trust could not be determined until the value of her estate and that of the decedent was established on the alternate valuation date.⁸²

The United States Court of Appeals for the Seventh Circuit, by affirming the result in *Smith*, became the only circuit to sanction use of the equalization formula. Given the nonacquiescence of the government to the decision in *Smith*,⁸³ prudence dictates against use of an equalization clause, outside the Seventh Circuit, until the law becomes more settled.⁸⁴

Although the equalization formula has been hailed as potentially "the norm for future marital deduction planning"⁸⁵ the utility of this clause is debatable. Assume Smith died in 1981, leaving a \$600,000 estate in trust for his wife, and the wife has assets of her own worth \$260,000. If Mrs. Smith also died in 1981 leaving her estate to the children:

80. See Thomas, Esperti, & Katz, *New Variable Marital Deduction Technique Eliminates Uncertainty in Estate Plans*, 47 J. Tax. 194, 195 (1977) [hereinafter cited as Thomas]; Baines, *New Tax Court Decisions Broaden Estate Planning Potential of the Marital Deduction*, 45 J. Tax 292, 295 (1976).

81. 66 T.C. 415 (1976), *aff'd*, No. 77-141-6 (7th Cir. 1977), ¶ 13,215 U.S. Tax Cas. (CCH).

82. 66 T.C. at 427-28.

83. 1978-1 C.B. 3 (non acquiescence).

84. See Kabaker, *supra* note 68, at ¶ 1210.2. See also Goldstein & Coleman, *Marital Deduction Equalization Clauses*, 176 N.Y.L.J. 1, 1 (September 20, 1976).

85. See Kabaker, *supra* note 68, at ¶ 1210.3.

TABLE ELEVEN

	Equalization Formula	Maximum Marital Deduction Formula
Husband's Adjusted Gross Estate	\$600,000	\$600,000
Less Marital Deduction	<u>\$170,000</u>	<u>\$300,000</u>
Taxable Estate and Transfer Tax Base	\$430,000	\$300,000
Tentative Tax	\$132,000	\$87,800
Less Unified Credit	<u>\$47,000</u>	<u>\$47,000</u>
Estate Tax Liability	\$85,000	\$40,800
Wife's Taxable Estate and Transfer Tax Base	\$430,000	\$560,000
Tentative Tax	\$132,000	\$178,000
Less Unified Credit	<u>\$47,000</u>	<u>\$47,000</u>
Estate Tax Liability	\$85,000	\$131,000
Combined Estate Tax Liability	\$170,000	\$171,800

In the first example Smith's will used an equalization clause, and in the second the maximum marital deduction was taken. To equalize the aggregate \$860,000 Smith estates, the equalization formula triggered a \$170,000 marital deduction bequest to the wife, which grossed her estate up to \$430,000. Use of the equalization clause yielded a tax "savings" of \$1,800.

This benefit is illusory, for a decision to use the maximum marital deduction would defer payment of \$44,200 until the death of Mrs. Smith, as only \$40,800 in estate taxes are due at the death of her husband instead of the \$85,000 collectible if the equalization formula is employed. Loss of this sizable tax deferral coupled with the wife's inability to benefit from use of this money, and the income it would generate, militate against electing to use an equalization clause to save \$1,800 in combined estate taxes.⁸⁶

86. See Thomas, note 80 *supra*.

VI. OVERFUNDING AND THE MARITAL DEDUCTION

A. Introduction

One of the dangers of using a formula clause calling for "the greater of \$250,000 or one-half of the adjusted gross estate" to determine the marital deduction bequest is that the marital deduction could be overfunded. As shown in prior examples,⁸⁷ this could generate a huge tax bill upon the subsequent death of the wife. For moderate-sized estates, where the new \$250,000 maximum marital deduction exceeds one-half of the adjusted gross estate, and in those families where the surviving spouse has an estate of her own, overfunding is an important concern.⁸⁸ Furthermore, much, if not all, of the marital deduction property taxed through overfunding at the death of the wife could have passed without tax as part of the husband's estate due to the new unified credit against estate tax.⁸⁹

B. Minimum Marital Deduction Clause

Several devices have been developed to alleviate the overfunding pitfalls created by the new \$250,000 maximum marital deduction. One, the minimum marital deduction clause, seeks to pass to the surviving spouse no more than the amount necessary to eliminate the tax in the first estate, after considering the increased amounts sheltered from estate tax by the unified credit.⁹⁰ The chance of overfunding a marital deduction formula is greatly diminished by adding the following clause: "provided that this marital bequest shall be reduced by an amount, if any, needed to increase my taxable estate to the largest amount which will, after allowing for the unified credit against federal estate tax, result in no federal estate tax being payable by my estate."⁹¹

As an illustration,⁹² assume husband died in 1981 with a \$300,000

87. See notes 37-41 and accompanying text *supra*.

88. See notes 31-34 and accompanying text *supra*. See, e.g., Berall, *supra* note 2, at 34; Gamble, A "Reduce-To-Zero" Marital Deduction Formula for Estates Under \$500,000, 116 TR. & EST. 448, 448 (1977) [hereinafter cited as Gamble].

89. See note 88 *supra*.

90. See Gamble, note 88 *supra*, and Lerner, *supra* note 44, at 166. Use of the state tax credit would complicate any calculation. Although a state tax credit may mean less federal estate tax, it may also result in higher state inheritance taxes yielding no overall tax savings. *Id.*

91. Lerner, note 44 *supra*.

92. See *id.* at 164; Thomas, *supra* note 80, at 196.

estate left in trust for his wife. The wife then dies possessing the trust proceeds and no independent estate:

TABLE TWELVE

	Maximum Marital Deduction Formula Without Minimum Marital Deduction Clause	Maximum Marital Deduction Formula With Minimum Marital Deduction Clause
Husband's Adjusted Gross Estate	\$300,000	\$300,000
Less Marital Deduction	<u>\$250,000</u>	<u>\$124,375</u>
Taxable Estate and Transfer Tax Base	\$50,000	\$175,625
Tentative Tax	\$10,600	\$47,000
Less Unified Credit	<u>\$47,000</u>	<u>\$47,000</u>
Estate Tax Liability	-0-	-0-
Wife's Taxable Estate and Transfer Tax Base	\$250,000	\$124,375
Tentative Tax	\$70,800	\$31,300
Less Unified Credit	<u>\$47,000</u>	<u>\$47,000</u>
Estate Tax Liability	\$23,800	-0-
Combined Estate Tax Liability	\$23,800	-0-

Use of the minimum marital deduction provision reduces overall estate taxes by taking full advantage of the unified credit in the estate of the first spouse to die. Interspousal gifts made during the husband's lifetime will automatically reduce the estate tax marital deduction claimed. All allowable credits and deductions eliminating tax in the first estate are taken into account in adjusting the marital bequest.⁹³

93. See Gamble, *supra* note 88, at 449. The minimum marital deduction clause would automatically adjust for charitable deductions, items actually deducted on the estate tax return, the remaining unified credit, and credits for gift tax payments.

Although essentially sound from a tax perspective, the new minimum marital deduction clause may abrogate the testator's desire to pass property to his wife free of limitations. If, in the above example, husband's adjusted gross estate had been \$175,000 or less, no property would have passed to the wife and the residuary estate would have received all of the assets.⁹⁴

C. Disclaimer

If the incorrect formula is used or the testator has disrupted the drafter's estate plan by, for example, making inter vivos gifts of under \$200,000, disclaimers can be employed by the wife to prevent overfunding and reduce the excess marital deduction bequest.⁹⁵ State laws impose miscellaneous requirements for a legally valid disclaimer. Mere compliance with state law previously validated the disclaimer for federal estate tax purposes. However, the Tax Reform Act of 1976 purported to "federalize" the disclaimer rules to ensure uniformity.⁹⁶ In addition to being a bona fide disclaimer under local law, section 2518 must be satisfied to achieve any federal tax advantage from a disclaimer.

The 1976 Act required that a disclaimer was ineffective unless the disclaimed interest would "pass to" a person other than the disclaimant.⁹⁷ If a specific legatee disclaims a bequest and the property becomes part of the residuary estate, of which the wife is the beneficiary, the passing requirement has been fulfilled. Assuming the wife had not already received property equivalent to the maximum marital deduction, the marital deduction will consequently be increased.

It is with the converse of this fact pattern that the disclaimer language used by Congress in the 1976 law presents difficulties. If the wife attempts to disclaim a marital deduction bequest and the allegedly disclaimed property falls into the residuary trust, of which the wife is the income beneficiary, has the property "passed to" someone other than the disclaimant? The Revenue Act of 1978 an-

94. See Thomas, *supra* note 80, at 196.

95. See Berall, *supra* note 2, at 35; Kabaker, *supra* note 68, at ¶ 1208.

96. I.R.C. § 2518, as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(b)(1) and (e)(2).

97. See Frummer, *Using Disclaimers in Post Mortem Estate Planning: 1976 Law Leaves Unresolved Issues*, 48 J. Tax 322, 322 (1978) [hereinafter cited as Frummer]. A disclaimer is the refusal to accept property. The property disclaimed typically passes to those beneficiaries who would have received the bequest if the disclaimant had predeceased the testator. *Id.*

swered this important estate planning question in the affirmative.⁹⁸ This has drastically increased the utility of the disclaimer as an estate planning tool.⁹⁹

VII. MISCELLANEOUS CONSIDERATIONS

A. *Generation Skipping Transfers*

The Code generally attempts to tax any transfer of wealth whether it be by gift or by testamentary disposition. However, prior to the 1976 Act, the transfer of a trust corpus to the remaindermen upon the death of the life-income beneficiary escaped taxation unless the income beneficiary was either the grantor of the trust or retained a general power of appointment. By splitting the benefits of a transfer of wealth among two generations younger than the donor a level of taxation was skipped. Thus, donors would establish a "generation skipping" trust, with the son as the income beneficiary for life and the grandchildren acquiring the trust principal upon the death of the son. Estate taxes were payable only at the death of the donor, for there was no taxable transfer of wealth when the son died.¹⁰⁰

This method of tax avoidance was halted by the enactment of Chapter Thirteen¹⁰¹ in the Tax Reform Act of 1976, imposing a tax on generation skipping transfers. Subject to miscellaneous definitions and exclusions,¹⁰² the Code imposes a tax on the trust when the income interest of the son, the "deemed transferor," terminates,

98. See 47 FED. TAXES (P-H) ¶ 214 (1978), citing The Revenue Act of 1978, H.R. 13511, § 702(M), amending I.R.C. § 2518. See also Frummer, *supra* note 97, at 324-25.

99. In the example at text following note 37 *supra*, if the wife had disclaimed the entire \$250,000 bequest the tax consequences would have approximated the favorable illustration at text following note 39 *supra*.

100. See Taft, *Estate Planning - Post 1976*, 176 N.Y.L.J. 1, 1-2 (November 24, 1976); Kess & Malin, *Tax Reform Act of 1976: Levies on Estates, Gifts*, 176 N.Y.L.J. 1,2 (October 7, 1976) [hereinafter cited as Kess & Malin].

101. I.R.C. § § 2601.2622, as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(a). This was one of the more important provisions made by the Act.

102. One generation may be skipped where the generation skipping transfer goes to a grandchild of the grantor. Where the trust instrument establishes a life estate for the child with a remainder to the grandchildren the tax is not imposed upon termination of the life estate. Unfortunately, the maximum amount transferrable under this exception without triggering the generation skipping transfer tax is \$250,000 per child. See Kess & Malin, note 100 *supra*, citing I.R.C. § § 2613(c)(5) and (6), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(a).

and the remainder interest is to be distributed to the grantor-donor's grandchildren. The tax approximates the estate tax that would have been imposed if the bequest had been an outright transfer to the son and the son had subsequently bequeathed the property to the next generation.¹⁰³

Significantly, for purposes of calculating the son's or deemed transferor's maximum estate tax marital deduction, the gross estate is increased by the amount of the generation skipping transfer. Chapter Thirteen does not automatically raise the deemed transferor's estate tax marital deduction, it merely provides an opportunity to augment the marital deduction.¹⁰⁴

Assume decedent-son was the life-income beneficiary of a \$700,000 trust established by his father. Son's will leaves to his wife the maximum marital deduction which amounted to \$300,000, one-half of his \$600,000 adjusted gross estate. As provided for in his father's will, the \$700,000 trust corpus will now be distributed to the grandchildren. Because the son is a "deemed transferor" of a \$700,000 generation skipping transfer, his gross estate for purposes of computing the marital deduction is considered to be \$1,300,000. Ignoring the possible \$250,000 exemption,¹⁰⁵ and assuming no increase in the son's deductions, the potential estate tax marital deduction is now \$650,000—a figure in excess of the actual \$600,000 adjusted gross estate. The deemed transferor's estate escapes taxation at his death. While decedent is able to pass more property tax-free to his wife, her estate taxes will be much higher as a result.¹⁰⁶

TABLE THIRTEEN

	Increase in Marital Deduction for G.S.T.	No Increase in Marital Deduction for G.S.T.
Husband's Adjusted Gross Estate	\$600,000	\$600,000
Less Marital Deduction	<u>\$650,000</u>	<u>\$300,000</u>

103. See Kess & Malin, note 100 *supra*; Madden, *supra* note 22, at 438.

104. See Shaw, *The Generation Gap*, in 1 NYU THIRTY-SIXTH INSTITUTE ON FEDERAL TAXATION 179, 226 (1978) [hereinafter cited as Shaw], citing I.R.C. § 2602(c)(5)(A), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(a).

105. See note 102 *supra*.

106. See Shaw, *supra* note 104, at 226-27. See, e.g., Kabaker, *supra* note 68, at ¶ 1207.3.

Taxable Estate and Transfer		
Tax Base	-0-	\$300,000
Tentative Tax	-0-	\$87,800
Less Unified Credit	-0-	\$47,000
Estate Tax Liability	-0-	\$40,800
Wife's Taxable Estate and		
Transfer Tax Base	\$600,000	\$300,000
Tentative Tax	\$192,000	\$87,800
Less Unified Credit	\$47,000	\$47,000
Estate Tax Liability	\$145,000	\$40,800
Combined Estate Tax Liability	\$145,000	\$81,600

The aggregate tax cost of expanding the husband's estate tax marital deduction for the generation skipping transfer is \$63,400, the difference in estate tax liability between the two alternatives. However, when the tax on the generation skipping transfer¹⁰⁷ is layered into the example, the first alternative is undoubtedly more advantageous:

TABLE FOURTEEN

	Increase in Marital Deduction for G.S.T.	No Increase in Marital Deduction for G.S.T.
Taxes:		
Generation Skipping Tax	\$182,800	\$258,000
Son's Estate Tax Liability	-0-	\$40,800
Wife's Estate Tax Liability	\$145,800	\$40,800
Total Taxes	\$328,600	\$339,600

107. The tax is computed using the unified rate schedule for individuals set forth in I.R.C. § 2001(c). See I.R.C. § 2602(a)(1).

By utilizing the expanded marital deduction the deemed transferor has reduced his estate taxes and indirectly reduced the marginal tax rate on the generation skipping transfer. When the augmented marital deduction decreases the size of the deemed transferor's taxable estate to a figure below the \$175,625 exemption equivalent, protected from tax by the unified credit, the credit is available to offset the Chapter 13 Tax.¹⁰⁸

Besides resulting in lower overall taxes, use of the expanded marital deduction defers a significant amount of tax until the death of the surviving spouse. The disadvantage is that the deemed transferor's estate must pay more of the aggregate transfer taxes. Whether the son and his wife would want to pay additional taxes instead of compelling the trustee for the generation skipping trust to absorb some of these costs is an important planning consideration. Moreover, use of the generation skipping transfer to increase the marital deduction effectively disinherits the decedent-son's residuary beneficiaries which may be completely contrary to the son's testamentary intent.¹⁰⁹

B. Jointly Held Property

Before the Tax Reform Act of 1976, the value of jointly held property was included in the taxable estate of the first spouse to die to the extent they had provided the consideration. When the surviving spouse died the property was also included in their estate. The Act attempted to relieve this double taxation by declaring that only one-half of the value of a "qualified joint interest" would be included in the taxable estate of the first spouse to die. A qualified joint interest is a post-1976 taxable gift, from one spouse to the other of an interest in personal or real property.¹¹⁰

108. See Shaw, *supra* note 104, at 226-28. See generally I.R.C. § 2602(c)(3), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2006(a).

109. See Kabaker, *supra* note 68, at ¶ 1207.6. The will should explicitly deal with the possibility of the testator being a deemed transferor by containing the clause: "This gift (shall/shall not) be increased by reason of any generation-skipping transfer of which I am the deemed transferor (as these terms are defined in the Internal Revenue Code)." *Id.* at ¶ 1207.9.

110. I.R.C. § 2040(b)(2), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c)(1) and (d)(3). See Wall Street Journal, November 6, 1978, at 48 [hereinafter cited as Journal]. The amount of the taxable gift encompassed appreciation realized between the date of acquisition and the time that the gift tax return was filed. To create a qualified joint interest in real property an election must be made under I.R.C. § 2515. See I.R.C. § 2040(b)(2)(B)(i), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002(c)(1)(d)(3).

Although the new law essentially benefits the taxpayer, there are a few drawbacks to consider before advising a client to take advantage of the provision. If a qualified joint interest is created, only one-half of the jointly held property will be available to fund the marital deduction, as the other half is considered to be the property of the wife and part of her separate estate. Furthermore, to avoid the payment of gift taxes part or all of the husband's gift tax marital deduction may have to be used at the expense of the estate tax marital deduction.¹¹¹

Nevertheless, for those who still considered the benefits of creating qualified joint interests to outweigh these potential costs, the 1976 Act neglected to encompass the majority of joint interests, those created before 1977. Taxpayers with pre-1977 joint tenancy property would have to break up the tenancy and recreate a post-1976 joint tenancy subject to gift tax and administrative expenses, such as the cost of redrafting the deed. This was the only way a "qualified joint interest" could result. To simplify the conversion of pre-1977 joint tenancies into qualified joint interests, however, the Revenue Act of 1978 merely requires the donor-spouse to report a gift of his one-half interest on a gift tax return filed in any 1977-79 quarter.¹¹²

As with post-1976 transfers, the gift tax marital deduction and the \$3,000 annual exclusion can be used to soften the tax consequences of creating qualified joint interests out of pre-1977 joint tenancy property. To avoid consuming more of the gift tax marital deduction than is necessary, the gift should be reported for the earliest possible quarter. This is especially true if the jointly held property is a home or real estate which has been escalating in value.¹¹³

C. Carryover Basis

The Tax Reform Act of 1976 provided that for decedents dying after 1976, the decedent's adjusted basis in property carries over to the beneficiaries or the estate. This represented Congress' first attempt to tax the appreciation of assets transferred at death. The effective date of the revolutionary carryover basis provisions have

111. See Capouano & Rinsky, *supra* note 22, at 75.

112. I.R.C. § § 2040(d) and (e), as added by The Revenue Act of 1978, H.R. 13511, § 702(k)(2).

113. See Journal, note 110 *supra*.

been postponed by the Revenue Act of 1978 and will now apply only to property acquired from decedents dying after 1979. Consequently, the basis of property received from a person dying before 1980 is "stepped up" to the fair market value as of the date of death or alternate valuation date.¹¹⁴

Although plans to tax the appreciation of property passing at death have been temporarily shelved, the practitioner must consider the estate tax implications of the carryover basis provisions scheduled to come back into the law in 1980.

1. No Basis Step Up for Section 2056 Property

Generally, carryover basis assets receive a step-up in basis for federal and state death taxes attributable to the property's net appreciation.¹¹⁵ However, property passing to the wife through a marital deduction receives no basis step-up since no taxes are allocable to the marital deduction property.¹¹⁶

Logic would dictate that the husband should instruct the executor (in his will) to use property with the least appreciation to satisfy the marital bequest. Low basis assets will pass to the residuary estate and enjoy the basis step up attributable to the death taxes paid. However, the IRS will most likely respond to such schemes with an approach similar to that adopted in Revenue Procedure 64-19.¹¹⁷ The Service will undoubtedly insist that the property distributed to satisfy the marital bequest be fairly representative of the appreciated and non-appreciated property in the husband's estate.¹¹⁸

114. I.R.C. § § 1014(d), 1016(a)(23), and 1023, as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § § 2005(a)(1) and (3), as amended by The Revenue Act of 1978, H.R. 13511, § § 515 and 702.

115. Net appreciation is defined as the fair market value at the date of death less the decedent's adjusted basis after making the 1023(h) "fresh start" adjustment. I.R.C. § 1023(f)(2), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), and as amended by The Revenue Act of 1978, H.R. 13511, § 515 and 702.

116. See I.R.C. § 1023(c), as added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), and as amended by The Revenue Act of 1978, H.R. 13511, § § 515 and 702.

117. 1964-1 C.B. 682. See notes 73-76 and accompanying text *supra*.

118. See Capouanó & Rinsky, *supra* note 22, at 76; Isaacs, *The Operation of Section 1023*, 16 Duq. L. Rev. 45, 58 (1977) [hereinafter cited as Isaacs]. Overall tax savings may be achieved if appreciated assets are allocated to the marital deduction, for the payment of taxes when the spouse sells the low-basis property will decrease the size of her taxable estate.

2. *Formula Bequests and the Triggering of Gain*

If a pecuniary marital formula bequest is funded with appreciated carry-over basis property there will be a taxable gain to the extent that the distribution date value of the property exceeds the property's estate tax value.¹¹⁹ For example, if a \$100 pecuniary marital bequest is satisfied with an asset having a \$25 basis and is worth \$50 at the date of death, but worth \$100 at the date of distribution, gain must be recognized. Use of a tax value pecuniary formula would not change this result. However, because fractional share formula bequests are based on proportionate shares, and not on specific dollar values, such marital bequests escape taxation under the carry-over basis rules.

IRD and Section 691

Income in respect of a decedent (IRD) is the right to unrealized or unrecognized income, not properly includible in the final income tax return of the decedent, which passes to the beneficiaries or the estate. Since IRD is part of the decedent's gross estate, section 691(c) allows the recipient a deduction for the estate tax attributable to the IRD.

If the IRD had been taxed to the decedent, the commensurate income tax would have been calculated at a marginal rate. The mechanism used to calculate this marginal rate was the difference between the estate tax before and after inclusion of the IRD. Under the progressive tax structure, this formula effectively eliminated the highest tax bracket.

Counterbalancing the advantageous method of computing the IRD deduction was the rule that a marital deduction bequest of IRD, equal to the amount of the marital deduction, yielded no section 691 deduction to offset the IRD held by the surviving spouse. This position is justifiable since a marital deduction bequest of IRD was exempt from estate tax.¹²⁰ To avoid losing the IRD deduction, estate planners advised against allocating IRD to the marital portion, except when necessary to fund the maximum marital deduction.¹²¹

119. See Isaacs, *supra* note 118, at 61 citing I.R.C. § 1040 added by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(b).

120. See Treas. Reg. § 691(c)-1(a)(2) (1958); Rev. Rul. 67-242, 1967-2 C.B. 227.

121. See Bierman, *Section 691 After the Tax Reform Act*, in TWELFTH ANNUAL INSTITUTE

With the introduction of the carry-over basis provisions into the law, the IRD concept was completely restructured. In computing the estate tax attributable to the IRD, the 1976 Act required use of a formula producing an *average* instead of a *marginal* estate tax rate.¹²²

Under this type of formula the recipient of the IRD becomes irrelevant in determining the availability of the deduction. Hence, a bequest to the wife of all IRD items can be made without jeopardizing the deduction.¹²³ Since IRD is a depleting asset, tax savings are possible if the marital is funded with IRD and the wife has little or no taxable income. The wife will use the IRD for living expenses and none of this money will be taxable in her estate.

E. Administration Expenses, Losses, and the Marital Deduction

Certain items may be claimed as a deduction either to arrive at taxable estate or to offset the estate's taxable income.¹²⁴ If the estate income and the taxable estate are in essentially the same brackets then the expenses should be divided between the two. If one or the other is in a relatively higher tax bracket then it is better to use the administration expenses and other deductions to offset the higher bracketed amount, thereby reducing the marginal rate of taxation.

Restricting the post-mortem estate planner's flexibility to pick and choose where to claim the deduction is section 642(g). If administration expenses and losses are claimed as estate income tax deductions a "waiver" to the right to deduct these same expenses in arriving at taxable estate must be filed.¹²⁵ Waiver is a euphemism for "forever barred"; if there is any question as to the valuation of any item included on the estate tax return there can be disastrous tax ramifications. For example, if stock in a closely held corporation comprises most of the estate and the executor elected to deduct

ON ESTATE PLANNING ¶ 800 and 803 (1978).

122. The formula is as follows:

$$\frac{\text{IRD}}{\text{Federal/State Inheritance Tax} \times \text{Gross Estate}} = \$ 691(\text{c}) \text{ deduction}$$

I.R.C. § 691(c), as amended by The Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(4)(B).

123. See Cornfeld, *supra* note 6, at ¶ 412.

124. See, e.g., I.R.C. § § 213(d) and 642(g), as amended by The Tax Reform Act of 1976, Pub. L. No. 94-455, § § 1906(b)(13)(A) and 2000(d).

125. I.R.C. § 642(g), as amended by The Tax Reform Act of 1976, Pub. L. No. 94-455, § § 1906(b)(13)(A) and 2004(d).

administration expenses in computing the estate's or trust's net income, an upward revaluation of the closely held stock by the IRS, combined with the absence of administration expense deductions, will mean that higher marginal rates will be imposed against the estate.

If there are no valuation problems with property in the estate then using the deductions to reduce the estate or trust income taxes is recommended. Moreover, claiming these deductions to arrive at taxable estate could waste half of the potential offset if a fifty percent maximum marital deduction formula is used:

TABLE FIFTEEN

	Deduction to Arrive at Taxable Estate	Deduction to Arrive at Trust Net Income
Gross Estate	\$800,000	\$800,000
Less Administration Expenses	\$250,000	-0-
Adjusted Gross Estate	\$550,000	\$800,000
Less 50% Marital Deduction	\$275,000	\$400,000
Taxable Estate	\$275,000	\$400,000
Tentative Tax	\$79,300	\$121,800
Less Unified Credit	\$47,000	\$47,000
Estate Tax Liability	\$32,300	\$74,800
Trust Gross Income	\$300,000	\$300,000
Less Administration Expenses	-0-	\$250,000
Trust Net Income	\$300,000	\$50,000
Trust Income Tax Liability	\$195,490	\$22,590
Total Tax Liability	\$227,790	\$124,800

In the example, trading one dollar of marital deduction for two dollars worth of administration expenses proved to be poor strategy in light of the higher marginal trust income tax rates.

VIII. SUMMARY AND CONCLUSION

The primary function of the marital deduction is tax deferral until the death of the surviving spouse. Yet the planner is almost exclusively concerned with the secondary effect of the marital deduction, that of minimizing estate taxes. Efforts to take advantage of this ancillary function of the marital deduction were complicated when Congress unified the gift and estate tax systems and added an optional \$250,000 marital deduction.

As amply demonstrated, use of the marital deduction may actually result in higher aggregate estate taxes. The key objective of minimizing combined estate taxes is best accomplished when the estates of both husband and wife are equal in size. The careful use of interspousal gifts and formula clauses will achieve estate splitting.

Marital deduction clauses are also useful to give to the surviving spouse minimum or maximum control of the disposition of the decedent's estate. If the wrong formula were used, or the husband made interspousal gifts in conflict with his estate plan, a disclaimer or a minimum marital deduction clause can be used to blunt potential overfunding problems.

The marital deduction cannot be analyzed in a vacuum. A working knowledge of other code concepts—the unified credit, qualified disclaimers, carryover basis, and the generation skipping transfer tax—is essential. The breadth of this comment illustrates the complexity of the marital deduction. Only with a thorough grasp of the marital deduction and interrelating Code sections can the professional competently plan the estate of the client and his family.

TED TISHMAN

